MORNING BRIEFING
July 25, 2023

Workers Of The World: Strike!

Check out the accompanying chart collection.

Executive Summary: What's on our worry list? Yesterday, we covered urban office real estate, which adds credit availability concerns to our worry list. Today, we look at the labor market, specifically the unrest fomented by the effects of the pandemic and inflation. … Labor unions have grown in might, their members are striking, and employers are being forced to meet their demands. … So we are adding a renewed wage-price spiral to our worry list, which could happen if a rebound in wage inflation leads to resurgent consumer price inflation.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

US Labor Market I: Unrest. Labor unrest in the United States has been on the rise in recent years. In 2022, there were 424 work stoppages—including 417 strikes and seven lockouts—up 52% from 279 in 2021.

Several factors have contributed to the rise in labor unrest:

(1) *Pandemic's labor market effects.* The economic recovery from the Covid-19 pandemic unleashed several shockwaves that impacted the labor market. As the economy reopened, workers pushed for higher wages and better benefits. Many did so by quitting their jobs for better paying ones. They could do so because the demand for labor exceeded the supply since May 2021. The former can be measured as the sum of the household employment (which counts the number of people with jobs) plus job openings, while the latter is simply the labor force (*Fig. 1*). During May, excess demand for labor totaled 3.7 million workers.

The unemployment rate was 3.6% during June (*Fig. 2*). The short-term unemployment rate was only 2.9%, while the long-term rate was just 0.7%. The jobless rate for adults was 3.3%, while it was 11.0% for teenagers, which is a relatively low reading (*Fig. 3*). Here are June's unemployment rates by education level: college degree (2.0%), some college (3.1%), high school (3.9%), and less than high school (6.0%) (*Fig. 4*).

On the demand side of the labor market, job openings exceeded 10.0 million from June 2021 through January of this year, and have been hovering around 10.0 million through

May (*Fig. 5*). There were more than 1.5 job openings per unemployed worker from October 2021 through this May.

(2) *Pandemic's inflation effects.* The pandemic triggered a surge in inflation that started during 2021, peaked during the summer of 2022, and has moderated since then. At first, it seemed to cause a wage-price spiral. While wages increased rapidly, so did prices. Inflation-adjusted wages stagnated from mid-2020 through early 2022 (*Fig. 6*). Many workers were frustrated to see that their pay increases were eroded by rapidly rising prices. That seems to be changing in recent months, as wages have been rising faster than prices. But many workers may not be experiencing that improvement in their purchasing power.

(3) *Labor unions' heightened power.* Labor unions have grown more powerful as they've become more successful in organizing new workers and winning strikes in recent years. The labor unrest is being felt across a wide range of industries, including transportation, healthcare, and retail. Some of the most notable strikes in recent months have included:

- Thousands of hotel workers in Southern California walked off the job on July 3, 2023, demanding higher pay and better benefits. The strike involved workers at 19 hotels in Los Angeles, Orange, and San Diego counties. The workers are members of the Unite Here union.
- 20,000 nurses at Kaiser Permanente hospitals in California went on strike on July 11, 2023, demanding better staffing levels and safer working conditions. The strike involved nurses at 10 hospitals in the Los Angeles area. The nurses are members of the National Nurses United union.
- 1,400 pilots at Spirit Airlines went on strike on July 1, 2023, demanding better pay and benefits. The strike involved pilots at Spirit Airlines' main hub in Fort Lauderdale, Florida. The pilots are members of the Air Line Pilots Association.
- Thousands of Hollywood writers went on strike on May 10, 2023, demanding better pay and benefits. The strike involved writers for television, film, and streaming services. The writers are members of the Writers Guild of America, West.

(4) *More strikes ahead?* Important negotiations going on now that could lead to significant strikes include:

- The Teamsters and UPS are currently in contract negotiations, and there is a possibility of a strike if the two sides cannot reach an agreement. The Teamsters represent 340,000 UPS workers.
- The United Auto Workers (UAW) has three separate contracts with General Motors,

Ford, and Stellantis that are due to expire on September 14. Ahead of contract negotiations that began on July 13, the head of the UAW declared that its 150,000 members are prepared to strike against the Big Three US automakers if the automakers do not meet their demands.

These are just a few examples of recent labor unrest. Many other strikes are going on across the country, and we likely will see more in the coming months and years.

(5) *Flying wages.* On Saturday, CNBC *reported* that American Airlines raised its offer for a new pilot contract by more than $1 billion to match a preliminary deal last week between rival United Airlines and that carrier's aviators. The CNBC story observed: "Airlines and pilot unions had been negotiating new deals for years. Unions have won more bargaining power in the wake of Covid as the industry grapples with a prolonged pilot shortage just as travel demand recovered. Delta Air Lines pilots approved a new agreement in March for a deal that includes 34% raises over four years." American's new offer includes 21% pay bonuses and pay on par with that paid by United and Delta, according to their union, the Allied Pilots Association.

US Labor Market II: Wages & Prices. Now that almost everyone is bullish on the outlook for the economy and the stock market, a renewed wage-price spiral should be added to our worry list. Yesterday, we added the recession that is rolling into the commercial real estate markets, which might have adverse consequences for the widespread availability of credit. Our *risque du jour* is that the Fed concludes that a renewed wage-price spiral is a significant risk that can be avoided only by causing a recession.

Both price and wage inflation have been moderating so far this year, with the former down more than the latter. As a result, real wages have been rising at a pace consistent with a modest improvement in productivity growth. The risk is that a wave of labor strikes and expensive new contract settlements could cause wage inflation to rebound, forcing companies to raise their prices at a faster clip again. That would trigger a renewed wage-price spiral.

Don't get us wrong: We are still 75/25 on the odds of a rolling recovery versus an economy-wide recession. But we are spending more time thinking about what could go wrong. We continue to expect that rebounding labor productivity growth will be consistent with wages' rising faster than prices. We will be monitoring some of the following wage data:

(1) The quarterly Employment Cost Index (ECI) includes series for union and nonunion

compensation (*Fig. 7*). Since H2-2021, the latter has been outpacing the former. During Q1-2023, nonunion compensation rose 5.0% y/y, while union compensation rose 3.6%. Union workers feel like they've fallen not just below price inflation, but also below nonunion workers.

(2) The ECI compensation inflation rate is highly correlated with the core CPI inflation rate (*Fig. 8*). The Fed focuses on the ECI as one of the important indicators of wage inflation that can spiral up and down with price inflation.

(3) The good news is that labor market turnover is falling, as evidenced by the drop in the quit rate from a peak of 3.0% in April of last year to 2.6% this past May. This series tends to lead the ECI wages & salaries inflation rate by nine months (*Fig. 9*).

Calendars

US: Tues: Conference Board Consumer Confidence 99.2; Richmond Fed Manufacturing Index -10; S&P/CSI HPI 20-City Composite Index 1.5%m/m/-2.2%y/y; API Weekly Crude Oil Inventories. **Wed:** New Home Sales 722k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 5.50%; FOMC Statement. (Bloomberg estimates)

Global: Tues: Germany Ifo Business Climate Index, Current Assessment & Business Expectations 87.9/93.0/83.0; ECB Bank Lending Survey; Australia CPI 1.0%q/q/5.4%y/y. **Wed:** France Consumer Confidence 84; Japan Leading & Coincident Indicators; China Industrial Profit. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for LargeCap but fell for the SMidCaps. That typically occurs at this point in the quarterly reporting season, when LargeCap companies dominate the earnings releases. While none of the three indexes were at a record high for a 56th straight week, all three are up from their lows during February and March. Through the week ending July 21, LargeCap's forward earnings is 3.0% above its 54-week low during the week of February 10. MidCap's is 3.0% above its 55-week low during the week of March 10, and SmallCap's is 1.4% above its 72-

week low during the March 17 week. The forward earnings downtrend since mid-2022 for these three indexes has been relatively modest this time around compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. LargeCap's is now 3.3% below its record high at the end of June 2022; MidCap's is 5.3% below its record high in early June 2022; and SmallCap's is 12.1% below its mid-June 2022 record. Forward earnings momentum remains near two-year lows. The yearly rate of change in LargeCap's forward earnings was negative for a 25th straight week and up to -2.9% y/y from a 29-month low of -3.2% y/y during the June 23 week; that compares to a record-high 42.2% at the end of July 2021 and is up from -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -4.5% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -10.1% y/y rate is up from a 32-month low of -12.9% in mid-June, down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since last June, but 2023's estimates briefly ticked higher during the Q1 reporting season as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (-0.3% and 12.5%), MidCap (-11.0, 13.3), and SmallCap (-10.3, 13.0).

S&P 500/400/600 Valuation (*link*): Valuations rose for these three indexes through the July 21 week. LargeCap's forward P/E gained 0.1pt w/w to a 15-month high of 19.4. It's up 4.3pts from its 30-month low of 15.1 at the end of September, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.2pt to a 20-week high of 14.3, and is just 0.4pt below its recent 10-month high of 14.7 in early February. It's now up 3.2pts from its 30-month low of 11.1 at the end of September, which compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.3pt to a 20-week high of 14.0, which compares to a 19-week low of 12.5 during the May 12 week and is now just 0.3pt below its recent 12-month high of 14.3 in early February. It's 3.4 pts above its 14-year low of 10.6 at the end of September and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 27% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 28% discount to LargeCap's P/E last week is not much above its 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. SmallCap's P/E had been mostly above LargeCap's since 2003.

Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 110th straight week; the current 2% discount is near its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season, when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the estimate declines accelerated considerably for the three quarters ending through Q4-2022 before easing for Q1-2023. Looking ahead to Q2-2023, analysts are forecasting that the S&P 500's y/y earnings growth rate will mark its cyclical bottom with an 10.7% decline, down from -2.8% y/y in Q1-2023. On a pro forma basis, they expect the y/y earnings decline to bottom at -7.9% in Q2, down from a 0.1% gain in Q1-2023. S&P 500 ex-Energy earnings are forecasted to be down 2.2% y/y in Q2-2023, down from the 1.6% decline in Q1-2023 and the 7.4% drop in Q4-2022. Five sectors are expected to record positive y/y percentage earnings growth in Q2-2023, the same count that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q2-2023 versus their final earnings growth rates for Q1-2023: Consumer Discretionary (31.0% in Q2-2023 versus 56.2% in Q1-2023), Communication Services (9.8, -8.9), Industrials (9.0, 27.1), Financials (7.2, 7.7), Consumer Staples (3.5, 0.4), S&P 500 ex-Energy (-2.2, -1.6), Utilities (-2.5, -21.8), Information Technology (-2.6, -8.3), Real Estate (-3.8, -6.2), S&P 500 (-7.9, 0.1), Health Care (-27.5, -14.8), Materials (-31.4, -22.2), and Energy (-47.9, 21.0).

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2-2023 earnings season now 18% complete, the early indications from the companies that have reported so far suggest a similar earnings surprise than in Q1-2023 but a weaker revenues surprise. During Q4-2022, the earnings surprise was the lowest since Q4-2008, and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 90 of the S&P 500 companies finished reporting for Q2-2023, revenues are ahead of the consensus forecast by 1.3%, and earnings have exceeded estimates by 7.6%. At the same point during the Q1 season, revenues were 2.0% above forecast and earnings had beaten estimates by 7.8%. Just 59% of the 90 Q2 reporters that have reported so far through mid-day Monday has reported a positive revenues surprise, while 72% has reported an earnings beat. That's on pace for the weakest revenues surprise reading since Q2-2019; but the percentage with positive earnings surprises is on par with the prior three quarters. Their aggregate y/y revenues and earnings growth rates have improved from their Q1-2023 readings: to 7.8%

from 1.3% for earnings growth and to 8.1% from 7.1% for revenues growth. Over the past 57 quarters through Q1-2023, y/y earnings growth has trailed y/y revenues growth in only 15 quarters and for only five straight quarters, but it's likely to do so again in Q2-2023 once Energy sector results are reported. Significantly fewer companies have been reporting positive y/y earnings growth in Q2 (59%) than positive y/y revenues growth (78%). These figures will continue to change as more Q2-2023 results are reported in the coming weeks. While we expect y/y revenues growth rates to remain positive in Q2, earnings are sure to decline for a third straight quarter.

Global Economic Indicators

US PMI Flash Estimates (*link*): "July is seeing an unwelcome combination of slower economic growth, weaker job creation, gloomier business confidence and sticky inflation," according to July's flash estimate report. The US private sector in July slowed for the second time this year from May's 13-month high, according to flash estimates, as the manufacturing sector continued to contract while the service sector slowed. The *C-PMI* eased for the second month to 52.0 in July after climbing the first five months of the year from 45.0 in December to 54.3 in May. The *NM-PMI* also slowed for the second month to 52.4 after advancing the prior five months, from 44.7 at the end of last year to a 13-month high of 54.9 in May, while the *M-PMI* remained below the breakeven point of 50.0 for the ninth time in 10 months—though climbed 2.7 points in July to 49.0 from June's low for this year of 46.3. According to the report, the rate of output growth, measured across the manufacturing and service sectors, is consistent with GDP expanding an annualized quarterly rate of approximately 1.5% during the first month of the Q3, slowing from the 2.0% pace signaled by the survey during Q2. On the *price front*, following a resurgence in cost inflation during June, the rate of increase in *input prices* in July was the slowest since October 2020, dropping in line with the long-run series average. Most of July's increase reflected greater raw material prices, including oil, and increased wage bills. Meanwhile, *output prices* picked up in July, as firms sought to pass through higher costs and increased interest rate payments to customers, with the pace for service providers steeper than their long-run average. Meanwhile, good producers noticed little change in selling prices, with its rate of inflation "the joint-slowest in the current 38-month sequence of increase."

Eurozone PMI Flash Estimates (*link*): "Flash PMI signals steeper downturn and cooling price pressures at the start of the third quarter," was the headline of the report. The manufacturing sector remains entrenched in negative territory, while the service sector posted its slowest pace in six months. The Eurozone's *C-PMI* fell for the third month, to an eight-month low of 48.9, after climbing the prior six months from a 23-month low of 47.3 in October to 54.1 by this April. The *M-PMI* slipped for the sixth successive month to a 38-month low of 42.7 this month after advancing the prior three months, from 46.4 last October to 48.8 by January, while the *NM-PMI* fell for the third month to 51.1, after increasing the prior five months from 48.5 in November to a 12-month high of 56.2 this April. Looking at the two largest Eurozone economies, *Germany's C-PMI* fell back into contractionary territory, deteriorating for the third straight month, from 54.2 in April to an eight-month low of 48.3 this month. *Germany's NM-PMI* posted its first back-to-back decline since last September, falling to a five-month low of 52.0 this month; it had increased steadily from 46.1 last November to a 13-month high of 57.2 this May. *Germany's M-PMI* declined for the sixth straight month, from 47.3 at the start of the year to a 38-month low of 38.8 this month. Meanwhile, *activity in France* declined at its fastest pace since November 2020, with its *C-PMI* slowing for the fourth month, to a 32-month low of 46.6 this month, after advancing the prior three months from 49.1 in December to an 10-month high of 52.7 in March. France's *NM-PMI* also slipped for the third month, to a 29-month low of 47.4, after climbing steadily from 49.4 in January to an 11-month high of 54.6 in April. France's *M-PMI* was in contractionary territory for the 10th time in 11 months, sinking to a 38-month low of 44.5 this month. The *rest of the region* as a whole showed very modest growth for a second straight month, posting its weakest performance ytd, reflecting "an increasingly severe downturn in manufacturing and weaker demand growth for services." Looking at *inflation* for the overall Eurozone, measured across both sectors, *input price* inflation fell for a 10th straight month to its lowest rate since November 2020—dropping further below the survey's long-run average. Meanwhile, average *prices charged* rose at the slowest pace in 29 months.

Japan PMI Flash Estimates (*link*): Private-sector growth increased in July for the seventh consecutive month as the service sector's solid growth continued and manufacturing continued to decline, though at a softer pace than earlier this year. Japan's *C-PMI* held steady at 52.1 in July, according to flash estimates, after climbing the prior six months from 48.9 in December to 54.3 this May. The *NM-PMI* dipped for the second month to 53.9, after climbing the prior six months from 50.3 last November to 55.9 this May, while the *M-PMI* eased for the second month, from 50.6 in May to 49.4 this month—it's the eighth reading below 50.0 in nine months. According to the report, demand conditions at private-sector firms were less buoyant than during the previous survey period: Orders at manufacturing companies contracted at the strongest rate since March, while service providers experienced the slowest uptick in incoming business since the start of the year. Meanwhile, *input prices* accelerated for the first time since January, reflecting an increase in cost burdens for service providers—who largely attributed the rise to increased labor, fuel, and raw material costs. Higher operating costs pushed private-sector companies to raise their *output costs* faster in July—with both manufacturing and service providers contributing to the steeper rates.

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